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# **Colombia: Implications of the Financial Crisis**

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**An Intelligence Assessment**

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*ALA 85-10087  
August 1985*

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# Colombia: Implications of the Financial Crisis

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**An Intelligence Assessment**

This paper was prepared by [redacted]  
Office of African and Latin America Analysis. It was  
coordinated with the Directorate of Operations. [redacted]

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Comments and queries are welcome and may be  
directed to the Chief, South America Division, ALA,  
on [redacted]

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**Colombia: Implications  
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**Key Judgments***Information available  
as of 29 July 1985  
was used in this report.*

President Betancur, with a year left in office, faces the same dilemma confronting almost all Latin American heads of state: how to resolve external financial imbalances without jeopardizing political stability. Opinion polls show that the depressed state of the economy and continuing guerrilla violence have destroyed his popular standing. The new lending needed to begin an economic and political comeback, however, has generally been tied to politically unpalatable adjustment policies under IMF guidance. Betancur has attempted to soften domestic criticisms by proposing a self-imposed, IMF-monitored stabilization strategy. The IMF has given this approach its blessing, and bankers have tentatively offered \$1 billion in new loans based on its continuing implementation.

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This strategy will not be cost free, however. The policy moves introduced since the beginning of the year probably will cap GDP growth for 1985 at less than 2 percent, in our judgment. In addition, the policy moves likely in the coming months—more rapid devaluations, the removal of subsidies, price increases on staples, and continued monetary creation to finance the budget deficit—will probably push inflation in the short run above the 21-percent ceiling set by the government. On the positive side, the immediate pressure on foreign payments should ease with the new loan receipts and currency devaluation. Even so, we project a payments gap of \$1-1.5 billion for this year that will probably have to be covered by drawdowns in reserves and further gold sales.

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The political costs of the program go beyond worker and consumer grumbling about higher prices.

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its plan for ending guerrilla violence—which includes government jobs, small business credits, and land grants—will cost \$700 million. Because, in our judgment, the financial squeeze will prevent the government from fulfilling these goals, the prospects are that the shaky truce will completely collapse and many guerrillas will return to armed violence. At the same time, the budgetary squeeze will further undermine the counterinsurgency capabilities of the armed forces. We also are concerned that this situation will provide new opportunities for increased Cuban and Nicaraguan involvement with Colombian guerrillas.

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There is a slight chance that the up-front political and economic costs of Betancur's stabilization strategy will appear with sufficient speed and intensity to persuade the President to abandon the approach. In this case, we believe he would opt for populist policies, such as increased government spending, new subsidies, and eased access to credit. The short-term benefits of economic stimulation and enhanced popular support for the President would be quickly overshadowed by rising inflation, reduced access to bank credit, and intensified foreign exchange shortages. While such a policy path may garner local support in the short run, the results would only sow the seeds for later discontent.

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From the perspective of US economic interests, exporters will continue to suffer from Colombian import restrictions, and US investors will face tougher exchange controls, in our view. US firms and businessmen, as well as diplomatic officials, would be even more susceptible to terrorist attacks if the country's economic and security situation deteriorates even further. Bogota will require increased US assistance to sustain cooperation with Washington in narcotics enforcement. Finally, we believe the financial squeeze will encourage Bogota to campaign for a political solution to the Latin American debt situation and to at least explore expanded commercial relations with Soviet Bloc nations.

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The implications of Colombia's financial bind extend beyond the Betancur era. As long as funding is constrained, for example, Bogota's ability to develop its national resource base will be hampered. This is particularly true in the expensive petroleum exploration field. In addition, we believe continuing economic stagnation is likely to fuel further growth in illicit narcotics trade, because of the increasing attractiveness of marijuana and coca cultivation as compared to staple crops. This in turn has the risks of undermining government authority and control and increasing popular alienation from the political system—a development that would almost certainly affect the full range of US-Colombian bilateral issues.

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**Contents**

	<i>Page</i>
Key Judgments	iii
Introduction	1
Dashed Expectations	1
Economic Malaise	1
Pressures for Economic Adjustment	2
Colombia's Adjustment Strategy	5
Internal Vulnerabilities	6
Implications of the Adjustment Program	7
Dim Economic Prospects	7
Impact on the Insurgency	8
Implications for the United States Over the Short Term	10
The Trade Front	10
Investment Issues	11
Regional Foreign Policy Implications	11
Storm Clouds Beyond Betancur	12

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Figure 1



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## Colombia: Implications of the Financial Crisis

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### Introduction

President Belisario Betancur, who campaigned on a platform to improve Colombian living standards by reviving the economy and expanding social services, began his four-year term in August 1982 with a solid mandate. Soon after the election, Betancur announced that his second priority would be to end the political violence that has plagued the country for nearly 40 years by offering a broad amnesty to members of the four most prominent guerrilla groups. At the same time, he announced ambitious rural development plans aimed at eliminating the socioeconomic causes of South America's largest insurgency.

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Few observers doubt that Betancur, a populist of humble origin, is sincere in his goals. In our judgment, however, he initially underestimated the magnitude of each of these problems as well as the complexity of pursuing all of them simultaneously during a world economic slowdown. With one year left in office, Betancur faces the politically difficult task of implementing stabilization measures to ultimately strengthen the economy and regain the cooperation of international lenders without precipitating popular unrest. His efforts, in our view, could have a critical impact on the government's ability to encourage investment needed to develop Colombia's natural resources, sustain a truce with the guerrillas, strengthen the foundations of democracy, and support policies important to the United States, such as controlling narcotics.

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### Dashed Expectations

Betancur has failed on both his campaign pledges.

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the domestic economy is little better than it was three years ago, and the external accounts are worse. On the guerrilla front, sporadic violence continues because the government has been unable to implement a lasting peace program centered on rural

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development. Betancur's ability to take a firm corrective hand is constrained by political reality—according to the US Embassy, opinion polls showed last year that Betancur had lost half of his 70-percent approval rating, and, by April 1985, 62 percent of those interviewed in a reputable poll disagreed with his policies. A noted Colombian television news anchorman recently broadcast that the deterioration of Betancur's popularity is unprecedented in modern Colombian politics.

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### Economic Malaise

At the time of his inauguration in 1982, Betancur had counted on a strong influx of foreign credit to finance economic growth and diversification, according to US Embassy reporting. The availability of foreign financing at that time, however, was shrinking as the LDC debt crisis that began in Mexico spread throughout Latin America. At the same time, a depressed global economy prevented any trade-led boom. As a result, the populist-oriented Betancur turned to expansionary fiscal and monetary policies to accommodate political pressure groups and restore some growth momentum. Indeed, the public deficit rose from \$1.3 billion in 1982 to \$1.9 billion last year, and measured 8 percent of GDP. Over the same period, money supply expanded by an average of 21 percent annually. The results, as measured by standard statistics, are at best lackluster:

- GDP growth seemed to spurt by 3 percent in 1984, but that followed two years of annual growth of less than 1 percent, and living standards were still below the 1981 level.
- Inflation during the 1982-84 period was on the order of 20 percent annually, high by Colombian standards.
- Unemployment continued in the area of 10 to 15 percent, also high for Colombia.

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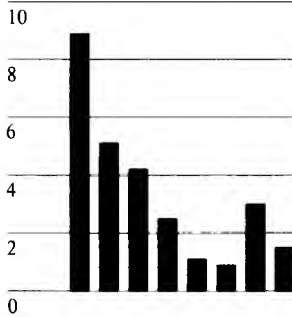
Far more worrisome from the international perspective was the steady addition of large current account deficits, which came at the hand of the government's own budget deficits, a slowdown in export earnings,



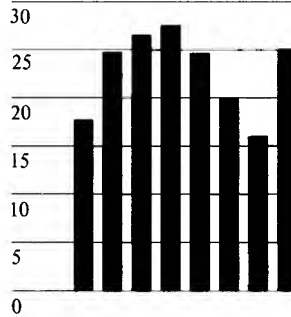
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**Figure 2**  
**Colombia: Selected Economic Indicators,**  
**1978-85**

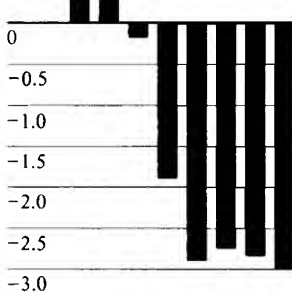
**Real Economic Growth**  
 Percent change



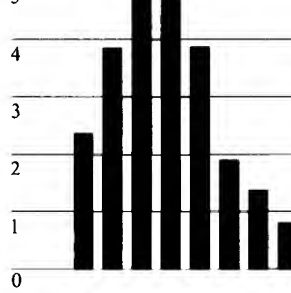
**Consumer Price Inflation**  
 Percent



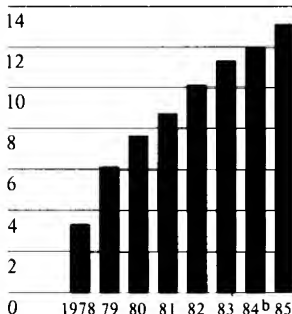
**Current Account Balance**  
 Excluding Official Transfers  
 Billion US \$



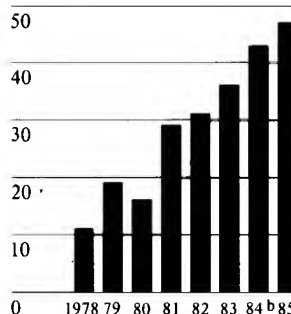
**Foreign Exchange Reserves**  
 End of Year <sup>a</sup>  
 Billion US \$



**Total Debt**  
 Billion US \$



**Debt Service Ratio**  
 Percent



<sup>a</sup> Excludes gold.

<sup>b</sup> Estimate.

<sup>c</sup> Projection—Assumes Bogota maintains its stabilization program.

### Colombia's Debt Profile

Unlike other major South American countries, Colombia so far has managed to service its \$12 billion medium- and long-term foreign debt without rescheduling. Although Colombia's external debt is smaller in relation to the size of its economy than that of many other developing countries—half the percent share of Argentina and of Chile, for example—it has been rising sharply, causing the ratio of debt service to exports to more than double to 36 percent between 1978 and 1983. This partially reflects the growing servicing cost of the \$8 billion government debt in the past six years. Bogota owes 40 percent of the public debt to international agencies such as the World Bank and the Inter-American Development Bank at lower interest rates and longer repayment terms, but it has increasingly depended on high-cost commercial loans to finance new development projects since 1978. Of the nearly \$5 billion in public-sector commercial loans, about 35 percent is owed to banks in the United States, and the remainder predominantly to banks in Japan and Western Europe. Although the public sector is generally current in servicing its obligations, the private sector is encountering difficulty. The government estimates total private foreign debt has increased to \$4 billion, including some \$1.2 billion in expensive short-term obligations. Most private debt is owed to US banks.

and a high debt repayment burden. Indeed, [ ] since Betancur took office, the current account deficit has averaged some \$2.5 billion annually. In the absence of adequate bank credits, Colombia has had to finance nearly half of the deficit by drawing down foreign exchange reserves from about \$5 billion at yearend 1981 to just over \$1 billion at yearend 1984.

### Pressures for Economic Adjustment

[ ] international creditors had advised Colombia to seek an IMF-supported agreement as early as last year, on the grounds that

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**Table 1**  
**Colombia: Balance of Payments, 1980-85**

Million US \$

	1980	1981	1982	1983	1984 <sup>a</sup>	1985 <sup>b</sup>
Current account balance	-172	-1,894	-2,893	-2,744	-2,840	-2,995
Trade balance	-297	-1,572	-2,244	-1,494	-1,291	-1,195
Exports (f.o.b.)	3,986	3,158	3,114	2,970	2,700	3,105
Coffee	2,375	1,459	1,577	1,537	1,799	2,000
Imports (f.o.b.)	4,283	4,730	5,358	4,464	4,000	4,300 <sup>c</sup>
Net services and transfers	125	-322	-649	-1,259	-1,549	-1,800
Capital account balance	1,200	1,800	2,000	752	946	1,260
Direct investment	51	228	337	513	411	400
Long-term loans	100	600	700	1,100	300	945
Short-term capital and errors and omissions	270	182	428	-629	-668	-500
Other	-1,028	94	893	2,083	1,894	1,735
Reserves <sup>d</sup>	987	-30	-940	-1,960	-537	-564

<sup>a</sup> Estimate.<sup>b</sup> Projection—assumes Bogota maintains its stabilization program.<sup>c</sup> In April, after Bogota presented to Colombia's international creditors the self-imposed austerity program that called for no import growth in 1985, it had to commit itself to ease import restrictions as one of the conditions to receive a \$300 million loan cofinanced by the World Bank. This accounts for the small import growth we project for 1985.<sup>d</sup> Includes change in foreign exchange reserves, excluding gold holdings, as reported in the IMF's *International Financial Statistics*.

failure to do so would curb access to external credit, deplete foreign exchange reserves, and lead to a severe economic decline. We believe that Betancur demurred because of the high political cost he perceived and pressures from such political groups as labor and business. In addition, we know largely from US Embassy reporting that Betancur faced conflicting advice and demands from his own advisers. For example, Finance Minister Junguito favored tighter monetary control, substantial reductions in the fiscal deficit, and a large devaluation; he publicly backed an IMF-supported program last year, [ ]

[ ] On the other hand, more liberal members of the economic team, such as Minister of Labor and Social Security Salazar and

Economic Development Minister Castro, who are also members of the opposition Liberal Party, contended that an IMF-supported program would have unacceptable social costs. [ ]

Pressures for economic adjustments that would bring unsustainable current account deficits under control reached a head earlier this year when bankers flatly refused to lend any more without an IMF stabilization program in place. Bogota had requested a short-term bridge loan to avert a standstill on debt repayments plus \$1.5 billion in new development loans, according to US Embassy and press reports. Bankers, however, [ ]

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**Betancur and the IMF**

Bogota last negotiated for an IMF loan in 1967, but rejected the Fund's proposals because they called for a large devaluation at a time when the memory of the inflationary burst after the November 1962 devaluation was fresh. Even so, Colombia successfully resolved balance-of-payments difficulties with its own set of economic measures. With this experience in mind and concerned about his declining popularity, President Betancur continues to reject a formal agreement with the IMF.

He has privately accused the Fund of colonialism and manipulation in the interest of the industrialized world, according to the publication Business Latin America.

the President believes the adoption of IMF austerity would prevent social reforms integral to seeking peace with the country's insurgents. Government officials have told creditors that Colombia does not need IMF balance-of-payments support, but, instead, commercial credits and project financing. The US Embassy reports President Betancur has publicly placed his prestige behind obtaining a financing arrangement with international creditors without a formal Fund standby. We believe that backing away from this position would be politically difficult.

balked because of their concern about dwindling foreign exchange reserves, the health of Colombia's banking system—the two largest private banks were battling liquidity problems—and Bogota's unwillingness to honor \$150 million in illegal loans made by the Panamanian affiliate of the largest bank.

In an apparent effort to regain lender confidence, Betancur began implementing elements of a self-imposed stabilization program. In the first three months of 1985, he increased gasoline prices, bus fares, and value-added taxes, cut government spending, limited wage increases, and lifted some import

**Table 2****Colombia: Original Economic Goals of Self-Imposed Austerity Program**

	1985	1986
Inflation (percent)	21	18
Economic growth (percent)	2	4
Public-sector deficit (percent of GDP)	4.9	3.8
Foreign debt (US \$ billion)	13.9	14.5
Debt service (percent of current revenues)	39.5	39.3
Change in foreign exchange reserves (US \$ million)	-75	+310
Export growth (percent)	10	14
Import growth (percent)	0	10

Source: Republic of Colombia Financing Plan, 1985-86, reported by the US Embassy.

restrictions. The IMF issued a favorable report on these ad hoc measures, and in April, the Bank Advisory Committee agreed in principle to Bogota's proposal for IMF monitoring of a comprehensive Colombian-designed economic adjustment program as a condition for new bank loans. For Betancur, the ability to substitute for a formal IMF stabilization program enables him to avoid opposition criticism of going "hat in hand" to the Fund. While Betancur's self-imposed IMF-monitored program is economically similar to a formal IMF standby accord, a "Colombian program" is more appealing to the country's political elites, opinion makers, and business leaders, making it easier to sell at home.

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**Colombia's Adjustment Strategy**

Under the terms of Colombia's IMF-monitored agreement with the Fund, Bogota's goal is to hold inflation below 21 percent for 1985, limit the drop in Central Bank foreign exchange and gold reserves to \$75 million (compared to \$524 million in 1984), reduce the public-sector deficit to 5 percent of GDP, and aggressively devalue the currency. [ ]

[ ] To meet these targets, the government will need by the end of 1985 to take additional policy moves such as eliminating some consumer subsidies, increasing gasoline prices, stepping up the rate of currency devaluation, raising taxes, cutting public spending by postponing some public works and limiting public-sector wage increases, and liberalizing import restrictions. [ ]

Thus far, Betancur has implemented stabilization measures on a piecemeal basis. US Embassy and press reports show that in the last few months progress toward economic adjustment has slowed, although he continues to resist labor pressures for wage increases and has lifted some additional import restrictions. The IMF-monitored program, however, will require the Colombian Government to become more consistent in implementing adjustments and to send both the IMF and the World Bank detailed quarterly progress reports. Fund and World Bank representatives also will visit Colombia every six months to monitor economic performance. If Colombia substantially fails to meet the performance criteria, as we believe they probably will, and the IMF refuses to grant waivers, [ ]

[ ] Bogota is required to negotiate a formal standby agreement with the Fund. [ ]

We judge the original economic goals of the self-imposed austerity program as unrealistic. For example, [ ] inflation remains unabated above the 21-percent limit—running at a 25-percent annual rate in June. Foreign exchange reserves continue to fall—dropping \$350 million during the first six months of 1985. Economic growth remains sluggish because of falling wages, rising unemployment, high interest rates, and lack of fresh capital as investors adopt a wait-and-see attitude pending next year's presidential elections. [ ]

Beyond the incentive to avoid the political damage of negotiating a formal IMF accord during an election year, Betancur's self-imposed austerity, if attained, will garner a sizable chunk of new money tied to the agreement. [ ]

[ ] commercial banks have tentatively agreed to provide a \$1 billion loan over two years. Under the special IMF monitoring arrangement, \$700 million of this would be for public-sector debt amortization, which will be applied primarily to the debts at the state oil and coal enterprises, \$200 million would be for new development projects, and \$100 million would be lent to refinance Colombia's largest private bank.

[ ] funds will be disbursed quarterly beginning later this year after the IMF issues its first report on economic performance. In addition, the World Bank will cofinance with international bankers a \$300 million loan for Bogota to finance imports needed to produce nontraditional export goods, [ ]

[ ] Half of the World Bank loan will be disbursed by the end of the year, with the remainder to be disbursed in 1986. [ ]

This is not to say that the issue of new funding is necessarily cut and dry. The Bank Advisory Committee has indicated its preliminary financial support, [ ]

[ ] In practice, however, some US regional banks have been opposed to similar pledges in new loan syndications for Chile and Ecuador. West European members of the Advisory Committee contend that private debt arrearages need to be brought current before syndication of the new money package. The Japanese, who, [ ] want a higher interest rate, are also reluctant to participate because of the Japanese Ministry of Finance's new requirement to set aside reserves against this type of loan. In mid-July, [ ] only half of the \$1 billion had been subscribed by bankers. [ ]

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**Internal Vulnerabilities**

Economists working with the Bank Advisory Committee for Colombia believe the country's adjustment program is modest enough in its objectives to have a good chance of success. We believe, nevertheless, that Colombian economic and political realities could easily derail the program. From an *economic* perspective, even if all the scheduled external funding is lined up, the program seems vulnerable on several counts:

- Although the government directly sets wages for about half the public sector, it only issues guidelines for state corporations and the private sector. Failure to comply with these guidelines and hold down wage increases would impede reduction of the fiscal deficit.
- The private banking sector is in poor financial shape, according to the US Embassy. Any austerity-induced bank failures—like those that recently occurred in Argentina and Ecuador—would necessitate central bank financial support that in turn would undermine monetary targets.
- Capital flight could resurge if the government-guerrilla truce breaks down completely, forcing a larger-than-expected drawdown of foreign exchange reserves.
- Continued delay in approving the government's \$1.2 billion budget for 1985, awaiting President Betancur's signature since May, will jeopardize attempts to hold down growth of the money supply. [redacted]

- The term sheet for the new foreign loan package must be approved by the Colombian Congress, but, [redacted] presidential campaign rhetoric is creating an unfavorable atmosphere for legislative approval and could delay the first disbursement of new money until next year. [redacted]

In our judgment, Colombia's *political* environment also threatens the adjustment program. Betancur is counting on his ability to continue selling the program

as Bogota's own decision to impose needed austerity and to rally support from the two major political parties and from business groups, [redacted]

[redacted] He is a veteran of the elite-controlled, bipartisan political system and hopes to capitalize on the tradition since the 1950s of muting ideological and policy disputes for the sake of the national interest. [redacted]

The task will not be easy. Betancur's adjustment measures have been under steady fire from key constituents since he first began to implement them in January, according to the US Embassy. Retailers, for example, charge that the new value-added tax schedule is inflationary and that the government is using business as a scapegoat. Transport owners marched in mid-May in Bogota protesting against speculation in the price of scarce spare parts. Industry leaders are publicly warning that another round of austerity is bound to increase social tension. [redacted]

In addition to problems from business and industry elites, we judge that Betancur will have substantial difficulty getting labor to accede to his programs. Trade union representatives are cautioning that the adjustments are merely disguised IMF recipes and make labor peace unlikely, according to press reports. Embassy and press reports also indicate that organized labor, frustrated by the erosion of living standards, is increasingly challenging government policies:

- Public-sector workers in January demonstrated against the administration's 10-percent limit on minimum wage increases, resulting in several violent incidents in Monteria and Medellin.
- Some 35 labor leaders were arrested in four cities—Rionegro, Barrancabermeja, Bucaramanga, and Bogota—in February because of protests against wage restraint.
- Transport owners demonstrated in May for a freeze on gasoline prices.
- In May, after President Betancur turned down labor demands for salary raises and for the rejection of IMF-supported austerity measures, the pro-Soviet

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Confederacion Sindical de Trabajadores de Colombia (CSTC) publicly called for a June nationwide general strike, supported by most guerrilla groups.

[ ]

Betancur's political opponents also have caused him problems over economic questions, but have not been able to exploit the issue as much as they would like. Some leaders in the Liberal Party, the New Liberal Party, and the opposition left—particularly those serving in the Congress—have vehemently criticized the administration, according to the US Embassy. This has occurred despite the fact that Liberals are serving in the Betancur Cabinet. The Embassy notes that the opposition presidential candidates have been more restrained in their criticism, however, notwithstanding their desire to distance themselves from the government's economic policies. The principal reason, in our view, has been the President's threat to retaliate through his control of patronage to the other parties. Consequently, when Communists and other leftist forces in labor scheduled a national strike last June to press the administration on economic issues, the Liberal presidential candidate opposed the strike.

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[ ]

Looking a bit further down the road, Betancur's populist inclinations may also hinder economic adjustments. The US Embassy reports that in a recent speech he announced that in the last year of his administration he would emphasize:

- Creating new jobs.
- Holding down price increases on basic products.
- Reorienting public investments to community services, health, housing, and education.

We believe that Betancur's continued hope that he can have it both ways—austerity and increased welfare—portends difficulties in keeping the deal with the IMF and the commercial banks on track. At a bare minimum, it sends a signal to labor and business groups that sustained political pressure could pay economic dividends.

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#### **Implications of the Adjustment Program**

We judge that because of sheer financial necessity Betancur will try to continue self-imposed stabilization for at least the next 12 months. Even so, we do

not believe that the implementation of self-imposed stabilization policies will produce major economic improvements, and they are very likely to result in political strains for him and any successor government.

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#### **Dim Economic Prospects**

To meet external financial targets, even self-imposed stabilization will have to slow economic growth in most key domestic sectors for a time. According to US Embassy and press estimates, agriculture and commerce will remain slack for at least the rest of this year and probably into 1986 as well. Judging from the policy changes already introduced—higher taxes, lower government spending, and reduced public investment—it is hard to see economic growth above 1.5 percent for 1985, a conclusion shared by a number of other observers. The growth slowdown will also be fed by the indirect effect of current austerity policies. For example, the real decline in government spending will depress construction activity and employment. Higher unemployment probably will squeeze consumer demand, in turn slowing industrial production.

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Under the Colombian plan, we believe inflation will rise above the 18-percent rate posted at the end of last year. Considering more rapid devaluations, the removal of subsidies and consequent price increases on staples, and continued monetary creation to finance the budget deficit, Bogota would be extremely lucky to keep inflation below its 21-percent target ceiling. We, like others, believe that, if anything, inflation will break this level and could easily hit 25 percent. Regardless of the exact inflation rate, as economic austerity begins to bite, we foresee:

- Middle-class groups staging cost-of-living protests.
- Influential agricultural interests pressing for higher support prices.
- Labor striking for wage hikes and more public spending to ease unemployment.
- The military demanding additional funds to help them make up for the loss in real purchasing power.
- Businessmen insisting on restraints on labor costs and the return to growth-oriented policies.

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**Table 3**  
**Colombia: Comparative Economic Performance**  
**Projections for 1985**

	Chase Econometrics	Wharton Econometric Forecasting Associates	Data Resources Inc.	Business International	Fedesarrollo <sup>a</sup>
GDP growth (percent)	3.1	1.8	1.9	0.5	0.5
Inflation (percent)	26	23	24	28	25-30
Current account balance (US \$ billion)	-1.4	-1.5	-1.7	-1.5	-1.5-3.0

<sup>a</sup> A private Colombian economic research foundation that compiles projections of the country's private sector and academic community.

On the external side, we expect another large payments deficit in 1985 despite adjustments. Given first quarter 1985 trade results and some preliminary trading partner data, we estimate that Colombian exports could be up 10 percent this year, a \$270 million gain in sales. We also judge that imports will rise slightly as the government relaxes controls to meet commitments to the World Bank. In our opinion, Colombia will post a \$1.2 billion trade deficit in 1985, roughly in line with private forecasts, which put the deficit in the range of \$500 million to \$1.5 billion. The service deficit, in our opinion, will grow mainly because of higher interest payments obligations to service the growing stock of debt. [ ]

The inability to eliminate the current account deficit as we and others project makes continuing foreign exchange difficulties almost inevitable. [ ]

[ ] we estimate Colombia will receive capital inflows of no more than \$2 billion in 1985, but probably will require something on the order of \$3 billion to cover the projected current account deficit while another \$500 million in capital leaves the country. With \$500 million in scheduled disbursements from the current loan, and \$430 million from World Bank and Inter-American Development Bank project financing loans, the Colombians still face a projected payments shortfall of about \$1-1.5 billion

even if they can attract \$400 million in direct investment as they did in 1984. Thus, we believe that in 1985 Bogota will probably need to continue to heavily draw down reserves—despite its pledge to the contrary—and sell gold to avoid declaring a standstill on foreign payments. [ ]

We believe political opponents, motivated by self-interest, will probably exploit economic difficulties. President Betancur is losing any remaining influence over the country's restive labor unions, and growing economic problems could cast a pall over his Conservative Party ambitions to retain the presidency in the 1986 elections. The new political party Union Patriótica—launched by the guerrilla group Revolutionary Armed Forces of Colombia—will increase pressures for Betancur to deliver the economic promises made to the guerrillas as part of his plan to end political violence in the country. [ ]

#### **Impact on the Insurgency <sup>2</sup>**

In our judgment, Betancur's program to stabilize the external accounts could undermine the government's commitment to make peace with the guerrillas and

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eventually could help swell insurgent ranks. In its nationwide truce with the leading guerrilla groups last August, the government promised not only to reintegrate the guerrillas into the political system, but to put them on the government payroll for a year at minimum wage, to grant them credits to establish small businesses, and in some cases to give them land.

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[redacted] Bogota estimates it will need \$700 million for this rural pacification, which also includes subsidizing new schools, roads, and health facilities, and providing agricultural credits. [redacted]

We doubt the government will be able to come even close to these goals. These offers, coming at a time when tougher economic policies are beginning to bite, have provoked complaints from the three major labor unions and from agricultural workers, according to US Embassy and press reports, and generated stiff resistance in Congress, where opposition legislators see an opportunity to criticize the administration and strengthen their position in the elections next year. The danger is that a failure by Bogota to live up to its commitment at this point could make it much more difficult in future negotiations to convince the insurgents that the government can deliver on its promises. Moreover, as economic conditions deteriorate, the insurgents may be able to attract increasing numbers of unemployed and alienated Colombians. Any major resurgence of rural and urban violence, in our view, would only further discourage foreign investment and, in turn, intensify the country's foreign exchange bind.

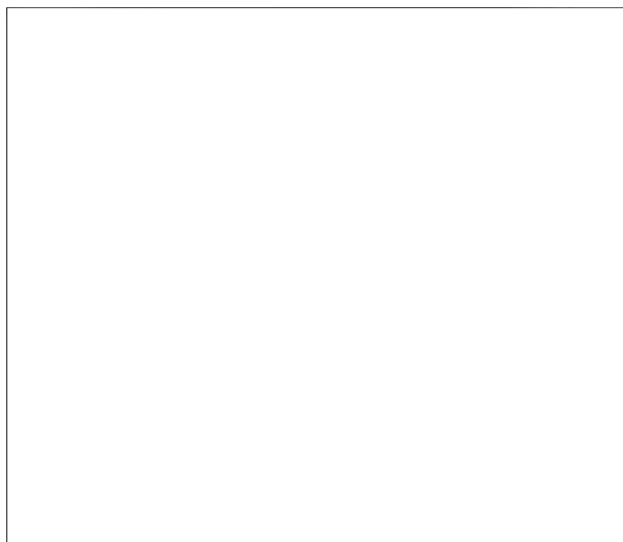
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[redacted]

From the military's standpoint, economic austerity will hit hard. As it is, the military's capability to contain the strengthened insurgency is being undermined by a 35-percent cut in the 1985 defense budget. The US defense attache reports that additional budget cuts will limit acquisitions and the ability to recruit. Such cuts, according to defense attache reports, are reducing the level of Army operations throughout the country, and, we believe, will lead to even more public criticism of the administration's policies. [redacted]

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If Betancur's economic program undercuts military capabilities while simultaneously increasing the drawing power of the militant insurgents, new opportunities for increased Cuban, Soviet, and Nicaraguan meddling will be created, in our view. [redacted]

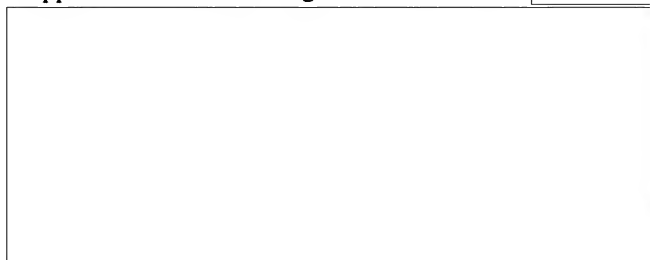
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[redacted] Havana has provided extensive support to Colombian guerrillas in the past and still maintains close ties to the insurgent groups. [redacted] members of the various Colombian guerrilla groups recently have been receiving training in Cuba and Nicaragua. Although Castro values his good relationship with Betancur, he would be tempted, in our view, to step up support for a more active guerrilla movement. [redacted]

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### ***Dangers Before Betancur Leaves Office***

*If President Betancur concludes that his self-imposed stabilization measures may contribute to serious political unrest, we believe he could resort to populist policies in his remaining months in office. Initially, we believe he would announce large-scale increases in government spending, new subsidies, and eased access to credit for farmers and other groups. Such actions would probably enable him to finish his term on a high note, but create serious problems for his successor. In addition, precedent suggests that foreign bankers would probably cease new lending, which would quickly translate into severe cash strains on Colombia. Instead of drawing down reserves, we believe Betancur would declare a moratorium on payments to creditors and receive public support for the action.*

*and demands for large wage increases would eventually follow. We also would expect a paralyzing nationwide strike.*

*The halt to debt servicing, in our judgment, would cut Colombia's access to foreign credit, direct investment, and development assistance. Once foreign exchange reserves dwindled, Bogota would be forced to use export earnings and gold sales to pay for essential imports on a cash-and-carry basis. There is also some danger that Betancur might be tempted to accept some help from narcotics traffickers, who in mid-1984 offered to repatriate and inject \$3 billion a year into Colombia's economy in exchange for amnesty, according to US Embassy and press reports.*

*With external constraints eased, we believe economic growth would increase. Stimulative fiscal policies, wage increases, and the ability to increase imports using frozen debt servicing funds would bolster the consumer demand needed to revive the economy. Price controls on staple items would be necessary to contain inflation, and tough foreign exchange controls would be required to prevent capital flight. We would expect this boom to be short lived, however, for rapid monetary expansion and tight price controls would erode business profitability and increase incentives for smuggling. As more goods went into the black market, we would expect product shortages to cause officially recorded inflation to spiral. Widespread economic distortions, rising unemployment,*

*Whatever initial support Betancur's populist policies were able to muster would quickly dissipate. Social unrest would drive conservative sectors of the military, the business community, and the President's own party to press for change and even move to impose a state of siege as it did in May 1984, in our view. To preserve Colombia's traditional power-sharing political system and ensure against radical shifts in political or economic policy, a Conservative-Liberal coalition of elites could attempt to strip Betancur of real power for the remaining months of his term.*

### **Implications for the United States Over the Short Term**

#### **The Trade Front**

Aside from the obvious issue of \$12 billion in debt repayment to international creditors, Colombia's economic difficulties will have numerous direct and indirect implications for US interests. From a trade standpoint, for example, Bogota's economic problems will affect both export and import flows. As far as US sales to Colombia are concerned, the IMF's *Direction*

*of Trade* statistics already shows that exports declined about 8 percent to \$1.4 billion in 1984—the lowest level since 1978. US sales to Colombia are likely to remain depressed as Bogota tries to conserve foreign exchange and devaluations make imports more expensive. On the other side, the Betancur government probably will increasingly criticize US countervailing duty actions because of the need to boost its own exports.

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President considers US sugar and coffee quotas especially onerous, and he objects to US tariffs on cut flowers, leather goods, and textiles. [ ]

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While trade tensions with the United States are likely to rise, there is also a new area of potential trade concern that is beginning to emerge. Growing commercial relations with the Soviet Bloc, partly a result of Colombia's financial problems, may, in our judgment, lead to warming political ties. According to US Embassy and press reports, Bogota recently signed a six-year bilateral trade protocol in the \$25-30 million range with the Soviet Union. Press reports also indicate that the Colombian Government authorized Flo-ta Grancolombiana—the Colombian-Ecuadorean national shipping line—to establish regular general cargo service with the USSR for two years. [ ]

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#### Investment Issues

Colombian economic problems will also have spillover effects on the investment side. President Betancur recently signed an Overseas Private Investment Corporation (OPIC) bilateral agreement to attract new American investment. Nonetheless, we believe the \$4 billion US foreign investment stake in Colombia will remain vulnerable to tightening restrictions on dividend remittances and principal repatriation until payments stringencies ease. For example, the US Embassy reports that Bogota has proposed a new tax on foreign profits that would reduce remittances for all foreign companies. [ ]

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We also believe there is increased potential for terrorist violence against US investors that will only intensify if general conditions deteriorate in Colombia. The

US Embassy reported that in May guerrillas attacked an Occidental Petroleum oil drilling operation in the north and inflicted damages estimated by the company at \$2 million. In addition to sporadic sabotage, we believe insurgent groups may increase kidnappings of US citizens. [ ] guerrillas in this area had also developed a new tactic of extorting money from foreign investors by staging demonstrations, protests, and strikes for social services. [ ]

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#### Regional Foreign Policy Implications

Colombian economic problems will also have a number of implications for regional policy relations. Despite President Betancur's commitment to support stability in the Caribbean Basin, economic stringencies probably will limit Bogota's role in the Caribbean Basin Initiative. For example, foreign financing difficulties probably will undermine plans to sponsor a coal facility similar to the Mexican-Venezuelan oil assistance to Caribbean Basin countries. Betancur, however, will continue, in our view, to favor a regional settlement in Central America through the auspices of the Contadora Group, of which Colombia is a member. [ ]

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We expect that, as long as Betancur feels a financial pinch, he will continue campaigning for a regional political solution to Latin America's debt problems. According to a US Information Agency poll last year, a substantial number of educated Colombians cited high US interest rates as a principal cause of Colombia's debt difficulties, and about half of them viewed a debtors' cartel as a possible remedy. [ ]

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[ ] he continues to call for renegotiation of debt on longer terms, with payments limited to a fixed percentage of export earnings. Recently, Betancur has been seized with the proposal to sponsor a "Marshall Plan" for Latin American economic reconstruction, an initiative we expect him to tout in the future. The US Embassy reports Betancur worked hard to exert regional leadership in late July at Peruvian President Garcia's inauguration, trying to rally official support proposing that each industrial

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### ***Economic Impact of Narcotics and Other Contraband on the Colombian Economy***

*Evidence of financial flows associated with drug production, as reported by the US Embassy, does not support the widely held belief that "black money" has been a source of stability for the Colombian economy. The US Embassy reports that earnings from illegal cocaine and marijuana exports have declined sharply since 1982, measured as a percent of GDP. At the same time, other exports have not risen to compensate for falling drug earnings. Thus, drug income has not offset this economic cycle for Colombia, but moved in the same direction as the economy as a whole and impeded government efforts to deal with its financial difficulties.* [ ]

*On balance, the annual value of Colombian exports of narcotics fluctuated between \$500 million and \$3 billion over the past five years.* [ ]

*Although drug earnings were strong in the early 1980s in the face of rising world demand, they dropped an estimated 50 percent to less than \$1 billion in 1984 as the price of both marijuana and cocaine fell steadily, according to press and US Embassy reports. By way of comparison, total recorded exports declined 25 percent to \$3 billion since 1980. Drugs thus constituted about one-third of total exports in 1984, but not all of these revenues returned to Colombia. Although illicit drugs do not account for all the contraband exports, drug earnings, however estimated, remain Colombia's second most important source of foreign exchange. The US Embassy reports that illicit trade—mainly smuggled consumer goods—financed by drug exports probably amounts to \$400-500 million a year, about 10 percent of recorded, or legal, imports.* [ ]

nation transfer to developing countries 1 percent of its GNP annually to relieve financial constraints. Moreover, he contends that international aid organizations should take a more aggressive lending role. [ ]

### **Storm Clouds Beyond Betancur**

The implications of Colombia's financial crisis go beyond the remaining year of Betancur's term. Without sustained economic stabilization, we believe Colombia will face a financial crunch in 1986 and 1987. Political unwillingness to carry through stabilization will probably result in continuing payment constraints and an exhaustion of the thin reserves cushion. We judge that continued failure to reduce the budget deficit and restrain monetary expansion would ultimately drive inflation into the three-digit level, increasing deep-set financial distortions and eroding bankers' confidence. With access to foreign credit cut, Bogota would have little choice but to resort to more protectionist trade and investment policies to shore up external accounts. Such policies would end Colombia's ability to attract foreign capital and technical expertise. [ ]

From an economic perspective, in our view, Colombia's external financial crisis and the need to make economic policy adjustments to correct it will have set back its economic development program for several years. To develop its resource base—coal, nickel, natural gas, and petroleum deposits—Bogota estimates it will require about \$3 billion in foreign credit through 1987. Development lending probably will be limited, however, for the next several years, because of foreign creditors' continued reluctance to increase their exposure in Colombia, or indeed anywhere in Latin America. Thus, we judge that Bogota will be unable to develop oil, coal, and nickel exports at a pace that would resolve external financial burdens before 1990 or enhance domestic recovery. [ ]

In particular, Bogota's efforts to become a significant net oil exporter will be set back. Although Colombia has the geologic potential to export \$1-2 billion worth of oil annually this decade, [ ] it needs \$700-800 million in investment capital

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to fund infrastructure and oilfield development. Such lending will be critically dependent on Bogota's compliance with the IMF-monitored adjustment program; even then, [ ] if the government fails to protect workers building pipelines to remote fields from terrorist attacks, further construction probably will cease. [ ]

populist, and anti-US groups among the lower classes. Such growing public disillusionment would have the potential to not only undermine government authority, but also weaken the country's traditional two-party system and politics of consensus. If this were to occur, Colombia could find itself in uncharted waters, a development that would almost certainly alter the nature of US-Colombian bilateral relations for years.

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We believe that another adverse consequence of economic stagnation over the next several years will be growth in the narcotics trade. We judge that during the rest of the Betancur administration Colombia will choose to continue close cooperation with the United States in fighting drug traffic. We also believe that mounting popular concern over the traffickers' terrorist tactics—demonstrated in the latest publicized INVANER-Gallup opinion poll—will probably strengthen any successor government's resolve in this regard. Bogota's financial squeeze, however, will increasingly inhibit Colombia's ability to interdict traffickers. At the same time, the economic incentives to enter the lucrative drug production and distribution markets will be on the rise because of deteriorating conditions in the legal economy. Marijuana and coca will probably become an even more important source of income for peasants, who will continue to reduce the cultivation of staple crops. Increased "black-market" flows will probably complicate government efforts to collect taxes and control the amount of money circulating in the economy. We believe large-scale clandestine flows of drug money to offshore banks also will continue to restrain capital formation and add to Colombia's payments vulnerabilities. [ ]

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From a political perspective, we expect prolonged economic hardship in Colombia—especially if marked by sharp changes in taxes, subsidies, and official prices—could run the risk of increasing middle-class alienation, fuel more crime and violence in the urban and rural areas, and strengthen the appeal of leftist,

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